SHORT-TERM INVESTMENTS AS A STABILIZING INFLUENCE IN INTERNATIONAL FINANCE

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I. Bills of Exchange

Primarily, the value of holding foreign bills as an element in stabilizing the condition of the international money market rests upon the same principle that applies when a bank goes into the domestic market and buys commercial paper. The principle is this, that should the bank find it necessary suddenly to replenish its reserves and to curtail loans as the readiest means of doing so, this curtailment, if made wholly in the bank's own locality, might not only occasion serious distress but possibly might result in partial failure of its object. Moreover, a bank naturally feels more disposed to exercise leniency toward its local dealers than to those outside, and will therefore consider itself under little or no obligation to renew paper bought in the open market. There is, of course, another and even stronger reason which operates to cause banks, when having surplus funds, to seek an outlet in the general markets of the country, namely, that in so doing the bank may virtually make selection from the best offerings of commercial paper emitted by firms of established credit and offered for sale by brokers of known reputation. These same principles, in substance, are those which render the foreign bill a high grade form of investment. These instruments, when carefully chosen, are of the very choicest quality of commercial paper; their payment at maturity may be demanded, and the bank holding them is, as a rule, under no obligation to renew. In calling for payment, in the ordinary course, the bank occasions no strain on the American market; but, on the contrary, through the operation, which gives command of gold or foreign credit, any existing strain may be relieved.

Securities Compared with Bills of Exchange

These statements are, of course, subject to some qualification, because, so closely are the great international money markets related, that extraordinary demands made by one upon another

may react to the disadvantage of the one making the demand.[1] We have seen how, in providing for the stabilizing of European exchange, the vast volume of American securities returned here has been sent in driblets. Had this not been done, the capacity of America to repurchase its securities from Europe might have been glutted and thus our ability to be of financial assistance in the European crisis would have been greatly lessened. The normal operations of trade and finance do not contemplate that debts be all paid at once (some of them are scarcely ever paid), and in the case of the securities returned from Europe, most of them were not in the form of obligations, payable either on demand or after a short time, but they were stocks which represented merely the shares of foreign investors in our railway or industrial enterprises, or bonds generally not payable for many years. There was, therefore, no legal or moral obligation on the part of America to redeem these stocks or bonds in cash. All that could be rightfully expected was that facilities be provided for their sale in the open market at such prices as they would bring and the holders of the securities were willing to take.

It is here that, on the score of immediate availability, the bill of exchange offers superior advantages.[2] It is a direct obligation

[1] The gradual restriction on lending which follows a rise in the discount rate of the Bank of England is thus referred to by Sonne (*The City*):

"It is rather a slow proceeding and one which practically has an equal result all over the world, as England is not in a position to demand of one individual country immediate repayment of the whole or part of the funds, lent out in this manner, but she must either definitely decline to renew such short loans, or agree to renew them only at a higher rate. . . . It has therefore naturally been doubted whether this more defensive method would achieve its aim, and be sufficiently sharp in a crisis like this, and whether it would not have been desirable to have an additional line of defence, a third, consisting of a big portfolio of short bills drawn on and accepted by foreign banks. By throwing such a portfolio of short bills on one individual country into the market, it would be possible quickly to turn the exchanges of that particular country in our favor, without at the same time considerably altering the position in relation to other trade centres. It was thought that this method—with which French financiers are especially familiar—in addition to the supply of English bills, would be desirable, and might be useful for the purpose of meeting in case of need, as a sort of counter attack, a drain on our gold stock from any particular source."

[2] "It was due to the circumstance that France had placed nearly all her capital in the shape of long loans, that—although she is one of the richest nations of Europe—her financial position was at first rendered very difficult."—*The City*, H. C. Sonne.

for the payment of money, either at sight or after the lapse of a short time—usually thirty, sixty or ninety days. Payment is not dependent upon the state of the market for its sale, as in the case of stocks or bonds, but merely upon the solvency of the drawer or acceptor. In other words, under normal conditions, the payment of the bill in accordance with its tenor may be relied upon absolutely.

Bills of Exchange at the Outbreak of the War

The outbreak of the great European War in the summer of 1914 showed, however, that the bill of exchange, though possessed of the advantages just enumerated, was nevertheless not without its imperfections. In other words, that the most perfect part of the delicate mechanism of international finance succumbed to the shock of war.

Not only did the temporary closing of the stock exchanges in Europe and America at the outset of the war stop for the time being the market for stocks and bonds, but moratoria in most of the leading European countries and in South America as well suddenly congealed the most liquid instrument of international finance—the bill of exchange. No other course was practicable. The credit mechanism, upon whose smooth workings the continued successful utilization of this important financial instrument depends, had broken down. Cover to meet maturing bills could not be provided.[3]

Disarrangement of the mails, closing of frontiers between belligerent countries, and temporary interference with neutral shipping owing to prohibitive rates of marine insurance, all added to the confusion. American tourists, liberally provided with funds of one kind or another, found them unavailable, and the government finally sent over a gold-bearing cruiser to relieve their embarrassment. Extraordinary deposits of gold were made to the credit of

[3] "The last days of July [1914] were certainly very difficult, and the organization of the banks, so far-reaching in its ramifications, passed through a severe trial, which it surely would have been able to surmount without any break in its machinery, if it had only been possible to receive the remittances due from abroad. It was the non-appearance of these which resulted in an actual money crisis. The sensitive discount market collapsed, as the accepting houses would soon be unable to pay their—on foreign account—accepted bills, because their customers did not send cover."—*The City*, Sonne.

the Bank of England in Canada, by New York bankers, to meet a large volume of maturing New York City bonds.

Governmental Protection to Bank of England

The most telling remedy invoked in this extraordinary crisis was the act of the British government in agreeing to indemnify the Bank of England against loss in discounting bills accepted prior to August 4. Immediately, the bills, which had been a dead weight in the hands of their holders, were thrown upon the Bank, whose "Other Securities" rose from £65,351,656 on August 7 to £121,820,692 on September 2. This and other measures were so effectual that it has been estimated[4] that of the £350 to £500 million of bills running at the outbreak of the war only about £50 million would remain unpaid at the end, chiefly because the debtors belonged to hostile countries, and on this unpaid sum a substantial recovery is not improbable.

Various devices were resorted to in disentangling the situation in the respective countries, government intervention being relied on chiefly. In Russia an arrangement was made whereby merchants were able to buy sterling at a fixed rate, the funds being provided by the sale of Russian Treasury bonds in London.

Foreign Bills a Profitable Bank Investment

From the pure banking standpoint the object of handling these bills is the profit derived from the discounts or commissions charged. They constitute a prime type of banking paper, even the so-called "finance bills" being usually drawn against adequate collateral and by houses of established standing. But in addition to the protection afforded to the exchange rate, and to the gold stock of a country, these bills constitute a form of international currency of great service in carrying on the world's trade.[5] This service is performed without converting into fixed capital the commitments it requires, the most liquid form of credit known being employed.

[4] Sonne, *The City*.

[5] "The justification of the English accepting houses and bill brokers and banks (in so far as they engage in this business), is the fact that they are assisting trade and could not live without trade, and that trade, if deprived of their services, would be gravely inconvenienced and could resume its present activity only by making a new machinery more or less on the same lines."—*International Finance*, Hartley Withers.

Additional to the influences already recorded, the holding of a choice line of foreign bills constitutes a ready means of enlarging the lending powers of a bank. Indeed, it has come to be the custom of some banks to regard bills of this character as virtually constituting a part of their reserves. Theoretically this may be going too far, but in practice a bill immediately convertible into cash does constitute at least a secondary form of reserve. This quality of the foreign bill stamps it as a most important element of the financial mechanism, by whose judicious use great flexibility can be assured in a bank's lending operations or even in those of the banks of an entire country, where a central bank or some other specially-designed piece of financial machinery acts as a monitor of the international money market.

The enormous benefit that may accrue by the accumulation of short-time obligations was shown most strikingly in the case of the payment of the war indemnity exacted by Germany from France at the close of the Franco-Prussian War. More than 5,315,000,000 francs were paid and only 275,000,000 francs in French coin left the country.

When heavy payments are to be made abroad, the work of accumulating exchange is sometimes spread over considerable periods so as not to cause disturbance and occasion a rise in price. The payment of $50,000,000 by the United States for the rights of the French Company in the Panama Canal was at least partly made in this way.

Another useful purpose of accumulated trade credits is shown in the following statement:[6]

> The Japanese purchase of approximately $30,000,000 British Treasury bills, paying for them in American funds on deposit here, is one of the interesting developments of war financing. Japan has built up a credit in this country by balance on her trade with us—by selling us more goods than we have sold her. The most important item in this trade was raw silk, of which we took from her this year 169,000 bales—an increase of 20,000 bales over 1913–14. About $50,000,000 of this favorable balance is said to have been on deposit in New York, and out of this the $30,000,000 was paid to Great Britain, but the amount did not leave this country and is being used to pay us for purchases by Great Britain.

Attack on Our Gold Reserves After the War

In Europe the practice of accumulating foreign bills in the possession of the great central banking institutions is quite common.

[6] *The Bache Review*, New York, Aug. 19, 1916.

These bills are bought when the rates are low and disposed of when they are high, thus tending to counteract the conditions leading to the exportation of gold. It is in this respect that the great New York banks, and perhaps the Federal Reserve Board, will doubtless find it advantageous, as opportunity offers, after the close of the war, to gather up a large volume of foreign bills for use in parrying the attack on America's gold reserves which many regard as sure to follow the closing of the war. There are some who fear this attack may be so severe as to endanger the maintenance of the gold standard itself. They base this fear upon several factors:

First.—The character of the various forms of "money" available as bank reserves, under the law.

Second.—The nature of the Federal Reserve Act, which places the direction of the larger affairs of banking and finance in the hands of men appointed by the President, and therefore under some political restraints which might prevent them from acting as freely or effectually as a private bank.

Third.—That following the war, in order to build up their shattered industries, to reduce their currencies more nearly to a metallic basis, and to effect a general reconstruction of their disordered finances, the European belligerents will enter into a desperate struggle for the world's gold.

Fourth.—That the United States will most likely undergo a sharp change in its economic position in the near future, losing much of its newly-gained foreign trade other than that represented by the export of war materials (the latter trade being cut off altogether), and experiencing a severe recession in domestic business activity.

The Probable Effects

Taking up the latter contention first, while it undoubtedly contains considerable truth, it ventures too far into the realm of prophecy to be accepted as an accurate representation of what will happen. It would be quite as good a guess to say that we shall retain a very considerable share of our new foreign trade, and that domestic business, influenced by a succession of good crop years, will continue active.

As to the struggle for gold, it will probably take place, and it is difficult to see how America can retain its present stock. No one expects that anything like the current abnormal balance of exports

can be maintained. On the other hand, we shall not for a long time, if ever, pay as much to Europe on account of principal and interest on our securities. Tourists' expenditures, and some other items which enter into the international financial balance, will be as large, and perhaps larger, than heretofore. If Europe can produce and sell cheap enough to menace our domestic industries through "dumping," this difficulty will no doubt encounter a tariff barrier. Europe still holds a large amount of our securities, and may find it advisable to part with more of them than have already been sent over.

The objection to the semi-political composition of the Federal Reserve Board may or may not be valid. That can only be determined by time. Presumably, even from the standpoint of politics, the Board will endeavor to shape its policy wisely and for the public good. A central bank could not do more than that, although it might be a little more prompt and vigorous in its application of remedies and a little less sensitive about criticism.

The first factor may prove the one of greatest importance. This country has not yet adopted the sound economic policy of establishing its banking credits upon gold alone. There are now available as bank reserves the following forms of "money," in substantially the amounts named: Legal-tender notes, $346,000,000; national bank notes, $682,000,000; silver, $568,000,000; Federal Reserve notes, $190,000,000—a total of more than $1,700,000,000. The legal tenders and the silver may be counted as part of the lawful money reserves of the national banks, while these and all the other forms of currency named are quite generally used for the reserves of the more numerous state banks. In the face of a severe world-wide struggle for gold, such as some people are expecting when the war ends, it becomes a question, particularly should trade and enterprise slacken here, whether Gresham's law would not become operative and deprive us of a large part of our gold stock.

II. Short-Term Obligations

A form of investment practically new to our money market has come into being since the beginning of the war—the short-term obligations of foreign governments. Prior to the European crisis we had made some loans to Canada and a few to several foreign countries, but these latter were of a somewhat spectacular

and temporary character. They were subscribed for more or less in a spirit of financial bravado—to show London what we might do if once we took the notion. But having thus gratified our financial vanity, we were quite content to dispose of the loans allotted us.

The loans made to Europe in the last two years are of an entirely different character. They have been made in all seriousness. France and Great Britain have needed our financial help. Other countries, long in the habit of borrowing from these financial giants, were compelled to turn here to make fresh loans or to renew old ones. But we ourselves were virtually compelled to make these loans, or to see American export trade seriously curtailed.

Our Investments in Short-Term Obligations

To what extent we have already entered upon the policy of investing in foreign short-term obligations may be seen from the accompanying statement:

Anglo-French five-year 5s	$500,000,000
British Government two-year 5s	250,000,000
British Bank loan	50,000,000
French three-year loan	100,000,000
French one-year notes	30,000,000
French special credit	55,000,000
Canadian Government	120,000,000
Canadian municipalities	120,000,000
Italian Government one-year notes	25,000,000
German Government notes	35,000,000
Swiss Government notes	15,000,000
Swedish Government notes	5,000,000
Norwegian Government notes	8,000,000
Argentine Government notes and bonds	75,000,000
Panama, Bolivia, and Costa Rica Government notes	4,500,000
Yucatan Government bonds	10,000,000
Russian Government acceptances	25,000,000
Russian Government credit	50,000,000
Chilian Government bank loan	10,000,000
Greece	7,000,000
Panama	3,000,000
Newfoundland notes	5,000,000
Total	$1,502,500,000

Since this compilation was made, some additional loans or credits have been reported, and it may reasonably be expected that the above total will soon rise to $2,000,000,000.

The chief benefit flowing from loans of this character, under normal conditions, consists in the command they give the lending nations over goods they need for consumption or for raw materials which enter into the manufacture of goods either to meet the home demand or for export. It need hardly be explained that capital is exported chiefly in the shape of goods, and that the principal and interest of capital borrowed are returned largely in the same manner. In other words, goods are wanted, not gold. Or, as recently said by Sir George Paish:[7]

> Our accumulated wealth for the greater part consists of the machinery of production, using the term in its broadest sense, of use for the purpose of production, but unavailable for any other purpose than production. Beyond the wealth we have built up at home in this manner, we have invested abroad a very large sum of money, and for all practical purposes this is the only part of our accumulated wealth that we are able to turn into consumable goods in order to supplement the nation's own productive power and income.

Their Use in Emergencies

But there may come a season when the shipment of goods to a country may be satisfied for the time being. There may exist an "adverse" trade balance which cannot be liquidated in merchandise. Gold will therefore flow out. It is at such a juncture that the possession of foreign bills, arising out of previous favorable conditions of trade, or possibly "finance" bills drawn against such an emergency, or short-term, foreign bonds, notes or credits, will serve a most useful purpose. They will fill the gap and prevent the exportation of gold, for they must either be paid or renewed.

The value of investing in short-term foreign loans has been thus clearly stated:[8]

> We may invest in short-term foreign loans that can be converted into credits to check a gold demand. We have already done some of that and will probably do a good deal more. There have been bankers so short-sighted as to object to our making any loans abroad, but I believe the day will come when you will find that those loans, convertible into credits, as they will be, will check gold withdrawals and form one of the most important safeguards of our gold stock.

The advantages of becoming a lending nation are well illustrated in the financial and commercial history of France and Great Britain. Such a policy has made their wealth cumulative. A most

[7] "War Finance," *Journal of Royal Statistical Society*, May, 1916.

[8] *Some Elements of National Foreign Trade Policy*, Frank A. Vanderlip.

striking witness of the value of having large foreign investments was given by the recent British loan placed in our markets. Under the extraordinary conditions now existing Great Britain could not have borrowed here at a favorable rate, if at all, without collateral. That collateral was offered, in abundance and of unquestioned character, because British investors had accumulated large holdings of the world's choicest securities.

By investing abroad the United States will greatly aid in the work of reconstruction after the war, and will also help in supplying nations not engaged in the strife with capital they would otherwise have obtained from the belligerents. Furthermore, we shall lay a basis for materially enlarging both our exports and imports, for capital exported will go to a large extent in the shape of the goods the borrowing countries require, just as the interest returns on our loans will come to us in the shape of goods we need and do not produce ourselves. Most of all, if we are to have the great attack upon our gold stock which many foresee, a goodly volume of foreign bills and short-term obligations in our possession will serve as a shield against such an assault.

Whether we are yet ready to share permanently in the field of international financial operations on any large scale is a matter which time alone will determine. But there can scarcely seem a doubt of the wisdom of safeguarding the near future by judicious short-term foreign investments.